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# Answers

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1 (a) (i) Implications of the acquisition of Canary Co for audit planning

**Individual financial statement audit**

Our firm has been appointed auditor of the new subsidiary which was acquired on 1 February 2012. This means that we must plan the audit of its individual financial statements, and then consider its implications for the audit of the consolidated financial statements.

First, we must plan to develop an understanding of the company, including its environment and internal control, as required by ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*. We must obtain an understanding of the relevant industry, regulatory and other external factors, the nature of the company's operations, ownership and governance structures, its selection and application of accounting policies, its objectives and strategies, and the measurement and review of its financial performance. Without this knowledge of the business we will be unable to properly perform risk assessment.

From our audit of the CS Group we will already have knowledge of the pottery industry, however, Canary Co's operations are different in that it specialises in figurines and makes some sales online.

Second, ISA 315 requires that the auditor obtains an understanding of internal controls relevant to the audit. Therefore we must document our understanding of Canary Co's accounting systems and internal controls. This is important given that Canary Co has different IT systems to the rest of the group.

Canary Co makes sales online, and due to the likely complexity of the online sales system, consideration should be given as to whether the use of an expert is required, or whether computer-assisted audit techniques (CAATs) can be used to obtain sufficient evidence on revenue.

It will take time to gain this knowledge and to properly document it. Given that the company's year end is less than one month away, it is important that we plan to begin this work as soon as possible, to avoid any delay to the audit of either the individual or the consolidated financial statements. We need to arrange with the client for members of the audit team to have access to the necessary information, including the accounting system, and to hold the necessary discussions with management. Once we have gained a thorough understanding of Canary Co we will be in a position to develop an audit strategy and detailed audit plan.

We have been provided with the CS Group's forecast revenue and profit for the year, but need to perform a detailed preliminary analytical review on a full set of Canary Co's financial statements to fully understand the financial performance and position of the company, and to begin to form a view on materiality. This review will also highlight any significant transactions that have occurred this year.

As this is an initial audit engagement, we are required by ISA 300 *Planning an Audit of Financial Statements* to communicate with the predecessor auditor. If this has not yet occurred, we should contact the predecessor auditor and enquire regarding matters which may influence our audit strategy and plan. We may request access to their working papers, especially in respect of any matters which appear contentious or significant. We should also review the prior year audit opinion as this may include matters that impact on this year's audit.

As the opening balances were audited by another firm, we should plan to perform additional work on opening balances as required by ISA 510 *Initial Audit Engagements – Opening Balances*.

**Consolidated financial statements audit**

As Canary Co will form a component of the consolidated financial statements on which we are required to form an opinion, we must also consider the implications of its acquisition for the audit of the CS Group accounts. ISA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* requires that the group auditor must identify whether components of the group are significant components. Based on the forecast results Canary Co is a significant component, as it represents 11.9% of forecast consolidated revenue, and 23.5% of forecast consolidated profit before tax.

As our firm is auditing the individual financial statements of Canary Co, our risk assessment and planned response to risks identified at individual company level will also be relevant to the audit of the consolidated financial statements. However, we must also plan to obtain audit evidence in respect of balances and transactions which only become relevant on consolidation, such as any inter-company transactions that may occur.

A significant matter which must be addressed is that of the different financial year end of Canary Co. We will have audited Canary Co's figures to its year end of 30 June 2012, but an additional month will be consolidated to bring the accounts into line with the 31 July year end of the rest of the CS Group. Therefore, additional procedures will have to be planned to gain audit evidence on significant events and transactions of Canary Co which occur in July 2012. This may not entail much extra work, as we will be conducting a review of subsequent events anyway, as part of our audit of the individual financial statements.

It may be that Canary Co's year end will be changed to bring into line with the rest of the CS Group. If so, we need to obtain copies of the documentary evidence to demonstrate that this has been done.

When performing analytical procedures on the consolidated financial statements, we must be careful that when comparing this year's results with prior periods, we are making reasonable comparisons. This is because Canary Co's results are only included since the date of acquisition on 1 February 2012 and comparative figures are not restated. Calculations such as return on capital employed will also be distorted, as the consolidated statement of financial position at 31 July 2012 includes Canary Co's assets and liabilities in full, but the consolidated income statement will only include six months' profit generated from those assets.

Materiality needs to be assessed based on the new, enlarged group structure. Materiality for the group financial statements as a whole shall be determined when establishing the overall group audit strategy. The addition of Canary Co to the group during the year is likely to cause materiality to be different from previous years, possibly affecting audit strategy and the extent of testing in some areas.

Finally, we must ensure that sufficient time and resource is allocated to the audit of the consolidated financial statements as there will be additional work to perform on auditing the acquisition itself, including the goodwill asset, the fair value of assets acquired, the cash outflows, the contingent consideration, and the notes to the financial statements. As this is a complex area we should consider allocating this work to a senior, experienced member of the audit team. Relevant financial statement risks and audit procedures in respect of goodwill are discussed later in these notes.

## (ii) Risks of material misstatement

### General matters

ISA 315 provides examples of conditions and events that may indicate risks of material misstatement. These include changes to corporate structure such as large acquisitions, moving into new lines of business and the installation of significant new IT systems related to financial reporting. The CS Group has been involved in all three of these during the financial year, so the audit generally should be approached as high risk.

### Goodwill

The client has determined goodwill arising on the acquisition of Canary Co to be \$45 million, which is material to the consolidated financial statements, representing 8.2% of total assets. The various components of goodwill have specific risks attached. For the consideration, the contingent element of the consideration is inherently risky, as its measurement involves a judgement as to the probability of the amount being paid.

Currently, the full amount of contingent consideration is recognised, indicating that the amount is certain to be paid. IFRS 3 (Revised) *Business Combinations* requires that contingent consideration is recognised at fair value at the time of the business combination, meaning that the probability of payment should be used in measuring the amount of consideration that is recognised at acquisition. This part of the consideration could therefore be overstated, if the assessment of probability of payment is incorrect.

Another risk is that the contingent consideration does not appear to have been discounted to present value as required by IFRS 3, again indicating that it is overstated.

The same risk factors apply to the individual financial statements of Crow Co, in which the cost of investment is recognised as a non-current asset.

The other component of the goodwill calculation is the value of identifiable assets acquired, which IFRS 3 requires to be measured at fair value at the date of acquisition. This again is inherently risky, as estimating fair value can involve uncertainty. Possibly the risk is reduced somewhat as the fair values have been determined by an external firm.

Goodwill should be tested for impairment annually according to IAS 36 *Impairment of Assets*, and a test should be performed in the year of acquisition, regardless of whether indicators of impairment exist. There is therefore a risk that goodwill may be overstated if management has not conducted an impairment test at the year end. If the impairment review were to indicate that goodwill is overstated, there would be implications for the cost of investment recognised in Crow Co's financial statements, which may also be overstated.

### Loan stock

Crow Co has issued loan stock for \$100 million, representing 18.2% of total assets, therefore this is material to the consolidated financial statements. The loan will be repaid at a significant premium of \$20 million, which should be recognised as finance cost over the period of the loan using the amortised cost measurement method according to IFRS 9 *Financial Instruments*. A risk of misstatement arises if the premium relating to this financial year has not been included in finance costs.

In addition, finance costs could be understated if interest payable has not been accrued. The loan carries 5% interest per annum, and six months should be accrued by the 31 July year end, amounting to \$2.5 million. Financial liabilities and finance costs will be understated if this has not been accrued.

There is also a risk of inadequate disclosure regarding the loan in the notes to the financial statements. IFRS 7 *Financial Instruments: Disclosures* requires narrative and numerical disclosures relating to financial instruments that give rise to risk exposure. Given the materiality of the loan, it is likely that disclosure would be required.

The risks described above are relevant to Crow Co's individual financial statements as well as the consolidated financial statements.

### Online sales

There is a risk that revenue is not recognised at the correct time, as it can be difficult to establish with online sales when the revenue recognition criteria of IAS 18 *Revenue* have been met. This could mean that revenue and profits are at risk of over or understatement. This is a significant issue as 30% of Canary Co's sales are made online, which approximates to sales of \$4.8 million or 3.6% of this year's consolidated revenue, and will be a higher percentage of total sales next year when a full year of Canary Co's revenue is consolidated.

Prior to the acquisition of Canary Co, the CS Group had no experience of online sales, which means that there will not yet be a group accounting policy for online revenue recognition.

There may also be risks arising from the system not operating effectively or that controls are deficient leading to inaccurate recording of sales.

### Canary Co management

As this is the first time that Canary Co's management will be involved with group financial reporting, they will be unfamiliar with the processes used and information required by the CS Group in preparing the consolidated financial statements. There is a risk that information provided may be inaccurate or incomplete, for example in relation to inter-company transactions.

### Financial performance

Looking at the consolidated revenue and profit figures, it appears that the group's results are encouraging, with an increase in revenue of 8% and in profit before tax of 1.2%.

However, this comparison is distorted, as the 2012 results include six months' revenue and profit from Canary Co, whereas the 2011 results are purely Crow Co and Starling Co. A more meaningful comparison is made by removing Canary Co's results from the 2012 figures, enabling a comparison of the results of Crow Co and Starling Co alone:

	\$ million 2012 forecast Crow Co	\$ million 2012 forecast Starling Co	\$ million 2012 forecast Crow Co and Starling Co	\$ million 2011 Actual Crow Co and Starling Co	% change
Revenue	69	50	119	125	(4.8%)
Profit before tax	3.5	3	6.5	8.4	(22.6%)

The analysis reveals that Crow Co and Starling Co combined have a significantly reduced profit for the year, with revenue also slightly reduced. The apparent increase in costs may be caused by one-off costs to do with the acquisition of Canary Co, such as due diligence and legal costs. However there remains a risk of misstatement as costs could be overstated or revenue understated.

### Possible manipulation of financial statements

A risk of misstatement arises in relation to Canary Co as its financial statements have been prone to manipulation. In particular, its management may have felt pressure to overstate revenue and profits in order to secure a good sale price for the company. The existence of contingent consideration relating to the Group's post acquisition revenue is also a contributing factor to possible manipulation, as the Group will want to avoid paying the additional consideration.

### Grant received

Starling Co has received a grant of \$35 million in respect of environmentally friendly capital expenditure, of which \$25 million has already been spent. There is a risk in the recognition of the grant received. According to IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* government grants shall be recognised as income over the periods necessary to match them with the related costs which they are intended to compensate. This means that the \$35 million should not be recognised as income on receipt, but the income deferred and released to profit over the estimated useful life of the assets to which it relates. There is a risk that an inappropriate amount has been credited to profit this year.

A further risk arises in respect of the \$10 million grant which has not yet been spent. Depending on the conditions of the grant, some or all of it may become repayable if it is not spent on qualifying assets within a certain time, and a provision may need to be recognised. \$10 million represents 1.8% of consolidated assets, likely to be material to the CS Group financial statements. It is likely to form a much greater percentage of Starling Co's individual assets and therefore be more material in its individual financial statements.

### New IT system

A new system relevant to financial reporting was introduced to Crow Co and Starling Co. ISA 315 indicates that the installation of significant new IT systems related to financial reporting is an event that may indicate a risk of material misstatement. Errors may have occurred in transferring data from the old to the new system, and the controls over the new system may not be operating effectively.

Further, if Canary Co is not using the same IT system, there may be problems in performing its consolidation into the CS Group, for example, in reconciling inter-company balances.

### Starling Co finance director

One of the subsidiaries currently lacks a finance director. This means that there may be a lack of personnel with appropriate financial reporting and accounting skills, increasing the likelihood of error in Starling Co's individual financial statements, and meaning that inputs to the consolidated financial statements are also at risk of error. In addition, the reason for the finance director leaving should be ascertained, as it could indicate a risk of material misstatement, for example, if there was a disagreement over accounting policies.

#### (iii) Audit procedures relating to goodwill

- Obtain the legal purchase agreement and confirm the date of the acquisition as being the date that control of Canary Co passed to Crow Co.
- From the legal purchase agreement, confirm the consideration paid, and the details of the contingent consideration, including its amount, date potentially payable, and the factors on which payment depends.
- Confirm that Canary Co is wholly owned by Crow Co through a review of its register of shareholders, and by agreement to legal documentation or by a Companies House search.
- Agree the cash payment of \$125 million to cash book and bank statements.
- Review the board minutes for discussion regarding, and approval of, the purchase of Canary Co.
- Obtain the due diligence report prepared by the external provider and confirm the estimated fair value of net assets at acquisition.
- Discuss with management the reason for providing for the full amount of contingent consideration, and obtain written representation concerning the accounting treatment.
- Ask management to recalculate the contingent consideration on a discounted basis, and confirm goodwill is recognised on this basis in the consolidated financial statements.

**Tutorial note:** *Procedures relating to impairment testing of the goodwill at the year end are not relevant to the requirement, which asks for procedures relating to the goodwill initially recognised on acquisition.*

#### (b) Ethical matters regarding the CS Group

Firstly, regarding the audit engagement partner attending board meetings, there is nothing to prohibit an auditor attending the board meetings of an audit client. Indeed it is common practice for this to occur, and there may be times when the auditor should attend in order to raise issues with management and/or those charged with governance pertaining to the audit.

However, the auditor attending the client's board meeting must be careful that they take no part in any management decisions made at the meeting. If matters not relevant to the audit are debated on which the auditor's opinion is sought, the auditor could be deemed to be involved with management decisions, or to be providing an additional service to the client which potentially creates a threat to objectivity.

IFAC's *Code of Ethics for Professional Accountants* and ACCA's *Code of Ethics and Conduct* both advise that if an auditor serves as a director or officer of an audit client, the self-review and self-interest threats created would be so significant that no safeguards could reduce the threats to an acceptable level. Accordingly, no partner or employee shall serve as a director or officer of an audit client. In summary, it is acceptable for the audit engagement partner to attend the board meetings, as long as he is not involved with making management decisions, and if he is not appointed to the board.

The second matter relates to an audit manager being seconded to Starling Co in a role as finance director. IFAC's Code refers to this situation as a temporary staff assignment, and states that the lending of staff by a firm to an audit client may create a self-review threat. Such assistance may be given, but only for a short period of time and the firm's personnel shall not be involved in providing non-assurance services or assuming management responsibilities.

It seems that in this case, the temporary staff assignment should not go ahead, as clearly the audit manager would be making management decisions involving the preparation of Starling Co's individual financial statements, and providing information for the consolidated financial statements. It is not likely that any safeguard could reduce the self-review threat created to an acceptable level.

Finally, our firm has been asked to help in the recruitment of a new finance director to Starling Co. IFAC's Code states that providing recruitment services to an audit client may create self-interest, familiarity or intimidation threats. The existence and significance of any threat will depend on factors such as the nature of the requested assistance, and the role of the person to be recruited.

The significance of any threat created shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. In all cases, the firm shall not assume management responsibilities, including acting as a negotiator on the client's behalf, and the hiring decision shall be left to the client.

The firm may generally provide such services as reviewing the professional qualifications of a number of applicants and providing advice on their suitability for the post. In addition, the firm may interview candidates and advise on a candidate's competence for financial accounting, administrative or control positions.

Therefore Magpie & Co may provide some assistance in the recruitment of the new finance director, but may wish to put safeguards in place such as obtaining written acknowledgement from the client that the ultimate decision will be made by them.

- 2 (a) (i) The terms of the engagement to review and report on Hawk Co's business plan and forecast financial statements should be agreed in an engagement letter, separate from the audit engagement letter. The following matters should be included in the terms of agreement:

**Management's responsibilities**

The terms of the engagement should set out management's responsibilities for the preparation of the business plan and forecast financial statements, including all assumptions used, and for providing the auditor with all relevant information and source data used in developing the assumptions. This is to clarify the roles of management and of Lapwing & Co, and reduce the scope for any misunderstanding.

**The intended use of the business plan and report**

It should be confirmed that the report will be provided to the bank and that it will not be distributed or made available to other parties. This will establish the potential liability of Lapwing & Co to third parties, and help to determine the need and extent of any liability disclaimer that may be considered necessary. Lapwing & Co should also establish that the bank will use the report only in helping to reach a decision in respect of the additional finance being sought by Hawk Co.

**The elements of the business plan to be included in the review and report**

The extent of the review should be agreed. Lapwing & Co need to determine whether they are being asked to report just on the forecast financial statements, or on the whole business plan including any narrative descriptions or explanations of Hawk Co's intended future business activities. This will help to determine the scope of the work involved and its complexity.

**The period covered by the forecasts**

This should be confirmed when agreeing the terms of the engagement, as assumptions become more speculative as the length of the period covered increases, making it more difficult for Lapwing & Co to substantiate the acceptability of the figures, and increasing the risk of the engagement. It should also be confirmed that a 12-month forecast period is sufficient for the bank's purposes.

**The nature of the assumptions used in the business plan**

It is crucial that Lapwing & Co determine the nature of assumptions, especially whether the assumptions are based on best estimates or are hypothetical. This is important because ISAE 3400 *The Examination of Prospective Financial Information* states that the auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use.

**The planned contents of the assurance report**

The engagement letter should confirm the planned elements of the report to be issued, to avoid any misunderstanding with management. In particular, Lapwing & Co should clarify that their report will contain a statement of negative assurance as to whether the assumptions provide a reasonable basis for the prospective financial information, and an opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework. The bank may require the report to be in a particular format and include specific wordings in order to make their lending decision.

**Tutorial note:** *Credit will also be awarded for discussion of other matters relevant to agreeing the terms of the engagement, such as confirming the fee and billing arrangements, and confirming the deadline for completion of the engagement.*

**(ii) General procedures**

- Re-perform calculations to confirm the arithmetic accuracy of the forecast financial statements.
- Agree the unaudited figures for the period to 31 May 2012 to management accounts, and agree the cash figure to bank statement or bank reconciliation.
- Confirm the consistency of the accounting policies used in the preparation of the forecast financial statements with those used in the last audited financial statements.
- Consider the accuracy of forecasts prepared in prior periods by comparison with actual results and discuss with management the reasons for any significant variances.
- Perform analytical procedures to assess the reasonableness of the forecast financial statements. For example, finance charges should increase in line with the additional finance being sought.
- Discuss the extent to which the joint venture with Kestrel Co has been included in the forecast financial statements.
- Review any agreement with Kestrel Co, or minutes of meetings at which the joint venture has been discussed to understand the nature, scale, and timeframe of the proposed joint business arrangement.
- Review any projected financial information for the joint venture, and agree any components relating to it into the forecast financial statements.

### Forecast income statement

- Consider the reasonableness of forecast trends in the light of auditor's knowledge of Hawk Co's business and the current and forecast economic situation and any other relevant external factors.
- Discuss the reason for the anticipated 21·4% increase in revenue with management, to understand if the increase is due to the inclusion of figures relating to the joint venture with Kestrel Co, or other factors.
- Discuss the trend in operating profit with management – the operating margin is forecast to improve from 30% to 33·8%. This improvement may be due to the sale of the underperforming Beak Retail park.
- Obtain a breakdown of items included in forecast operating expenses and perform an analytical review to compare to those included in the 2012 figures, to check for any omissions.
- Using the cost breakdown, consider whether depreciation charges have increased in line with the planned capital expenditure.
- Request confirmation from the bank of the potential terms of the \$30 million loan being negotiated, to confirm the interest rate at 4%. Consider whether the finance charge in the forecast income statement appears reasonable. (If the loan is advanced in August, it should increase the company's finance charge by \$1 million (\$30 million x 4% x 10/12).)
- Discuss the potential sale of Beak Retail with management and review relevant board minutes, to obtain understanding of the likelihood of the sale, and the main terms of the sale negotiation.
- Recalculate the profit on the planned disposal, agreeing the potential proceeds to any written documentation relating to the sale, vendor's due diligence report, or draft legal documentation if available.
- Agree the potential proceeds on disposal to management's cash flow forecast, and confirm that operating cash flows relevant to Beak Retail are not included from the anticipated date of its sale.
- Discuss the reason for not including current tax in the profit forecast.

### Forecast statement of financial position

- Agree the increase in property, plant and equipment to an authorised capital expenditure budget, and to any plans for the joint development with Kestrel Co.
- Obtain and review a reconciliation of the movement in property, plant and equipment. Agree that all assets relating to Beak Retail are derecognised on its disposal, and that any assets relating to the joint development with Kestrel Co are recognised in accordance with capital expenditure forecasts, and are properly recognised per IFRS 11 *Joint Arrangements*.
- Discuss the planned increase in equity with management to understand the reason for any planned share issue, its date and the nature of the share issue (rights issue or issue at full market price being the most likely).
- Perform analytical procedures on working capital and discuss trends with management, for example, receivables days is forecast to reduce from 58 to 53 days, and the reason for this should be obtained.

**Tutorial note:** *Credit will be awarded for other examples of ratios calculated on the figures provided such as inventory turnover and average payables payment period.*

- Agree the increase in long-term borrowings to documentation relating to the new loan, and also to the forecast cash flow statement (where it should be included as a cash flow arising from financing activities).
- Discuss the deferred tax provision with management to understand why no movement on the balance is forecast, particularly given the planned capital expenditure.
- Obtain and review a forecast statement of changes in equity to ensure that movements in retained earnings appear reasonable. (Retained earnings are forecast to increase by \$800,000, but the profit forecast for the period is \$10·52 million – there must be other items taken through retained earnings such as a planned dividend.)
- Agree the movement in cash, and the forecast closing cash position to a cash flow forecast.

### (b) Briefing notes

**From:** Audit manager

**To:** Audit partner

**Regarding:** Osprey Co

#### Introduction

These briefing notes will firstly recommend the principal audit procedures to be performed in respect of the costs of closure of the factory involved in the environmental contamination. I will also discuss the difficulties in measuring and reporting on environmental and social performance.

#### (i) Recommended audit procedures

- Review board minutes for discussion of the closure and restructuring, noting the date the decision was made to restructure, which should be before the year end.

- Obtain any detailed and formal plan relating to the closure of the factory and relocation of its operations, noting the date the plan was approved, which should be before the year end.
- Discuss with management any indication that the company has started to implement the plan prior to the year end, e.g. the date of any public announcement, the date that plant began to be dismantled.
- Physically inspect the factory for evidence that dismantling has commenced.

**Tutorial note:** *The procedures outlined above should establish whether a constructive obligation exists at the year end, in which case it is appropriate to recognise a provision according to IAS 37 Provisions, Contingent Liabilities and Contingent Assets. If there is no detailed formal plan in place, and no evidence that a valid expectation exists that the company will carry out the restructuring at the year end, then no provision should be recognised.*

- Obtain a breakdown of the \$1.25 million costs of closure and review to ensure that only relevant costs have been included, e.g. redundancy payments, lease cancellation fees. This is an important procedure for the potential overstatement of the provision.
- Cast the schedule for arithmetic accuracy.
- Agree a sample of relevant costs included in the provision to supporting documentation, e.g. redundancy payments to employees' contracts, lease cancellation fees (if any) to lease agreement.
- Enquire as to whether any gain is expected to be made on the sale of assets, and ensure that if so, the gain has not been taken into account when measuring the provision.

**Tutorial note:** *IAS 37 prescribes that only costs necessarily entailed by the restructuring and not associated with the ongoing activities of the business may be included in the provision. In practice this means that very few costs can be included, and costs to do with relocation of employees, plant and equipment and inventories, retraining staff, investments in new infrastructure are not included as they are related to ongoing activities.*

- Review the relevant disclosure note to the financial statements for accuracy and adequacy, where the provision should be treated as a separate numerical class and a description of it given.

**Tutorial note:** *Credit will also be awarded for procedures relevant to ascertaining whether the factory closure constitutes a discontinued operation, and procedures relevant to any consequential disclosure requirements.*

## (ii) Measuring and reporting on social and environmental performance

Many companies attempt to measure social and environmental performance by setting targets or key performance indicators (KPIs), and then evaluating whether they have been met. The results are often published to enable a comparison to be made year on year or between companies. But it can be difficult to measure social and environmental performance for a number of reasons.

First, targets and KPIs are not always precisely defined. For example, Osprey Co may state a target of reducing environmental damage caused by its operations, but this is very vague. It is difficult to measure and compare performance unless a target or KPI is made more specific, for example, a target of reducing electricity consumption by 5% per annum.

Second, targets and KPIs may be difficult or impossible to quantify, with Osprey Co's planned KPI on employee satisfaction being a good example. This is a very subjective matter, and while there are methods that can be used to gauge the levels of employee satisfaction, whether this can result in a meaningful statistic is questionable.

Third, systems and controls are often not established well enough to allow accurate measurement, and the measurement of socio-environmental matters may not be based on reliable evidence. In Osprey Co's case, it may not be possible to quantify how much toxic chemical has been leaked from the factory.

Finally, it is hard to compare these targets and KPIs between companies, as they are not strictly defined, so each company will set its own target. It will also be difficult to make year on year comparisons for the same company, as targets may change in response to business activities. For example, if Osprey Co were to expand its operating, its energy and water use would increase, making its performance on environmental matters look worse. Users would need to understand the context in order to properly appraise why a target had not been met.

## Conclusion

These briefing notes have shown that the environmental incident at Osprey Co will have an impact on our audit in that detailed audit procedures will need to be conducted to gain evidence regarding whether or not a provision for costs of closure should be recognised, and if so, its measurement. In addition, Osprey Co's intention to publish socio-environmental targets and KPIs is commendable, but it will be difficult for management to measure and report on these matters due to their often subjective nature.

- 3 (a) (i)** The circumstances described by the audit senior indicate that Jack Heron may be using his company to carry out money laundering. Money laundering is defined as the process by which criminals attempt to conceal the origin and ownership of the proceeds of their criminal activity, allowing them to maintain control over the proceeds and, ultimately, providing a legitimate cover for the sources of their income. Money laundering activity may range from a single act, such as being in possession of the proceeds of one's own crime, to complex and sophisticated schemes involving multiple parties, and



multiple methods of handling and transferring criminal property as well as concealing it and entering into arrangements to assist others to do so.

Heron Co's business is cash-based, making it an ideal environment for cash acquired through illegal activities to be legitimised by adding it to the cash paid genuinely by customers and posting it through the accounts. It appears that \$2 million additional cash has been added to the genuine cash receipts from customers. This introduction of cash acquired through illegal activities into the business is known as 'placement'.

The fact that the owner himself posts transactions relating to revenue and cash is strange and therefore raises suspicions as to the legitimacy of the transactions he is posting through the accounts. Suspicions are heightened due to Jack Heron's refusal to explain the nature and reason for the journal entries he is making in the accounts.

The \$2 million paid by electronic transfer is the same amount as the additional cash posted through the accounts. This indicates that the cash is being laundered and the transfer is known as the 'layering' stage, which is done to disguise the source and ownership of the funds by creating complex layers of transactions. Money launderers often move cash overseas as quickly as possible in order to distance the cash from its original source, and to make tracing the transaction more difficult. The 'integration' stage of money laundering occurs when upon successful completion of the layering process, the laundered cash is reintroduced into the financial system, for example, as payment for services rendered.

The secrecy over the reason for the cash transfer and lack of any supporting documentation is another indicator that this is a suspicious transaction.

Jack Heron's reaction to being questioned over the source of the cash and the electronic transfer point to the fact that he has something to hide. His behaviour is certainly lacking in integrity, and even if there is a genuine reason for the journals and electronic transfer his unhelpful and aggressive attitude may cast doubts as to whether the audit firm wish to continue to retain Heron Co as a client.

The audit senior was correct to be alarmed by the situation. However, by questioning Jack Heron about it, the senior may have alerted him to the fact that the audit team is suspicious that money laundering is taking place. There is a potential risk that the senior has tipped off the client, which may prejudice any investigation into the situation.

Tipping off is itself an offence, though this can be defended against if the person did not know or suspect that the disclosure was likely to prejudice any investigation that followed.

The amount involved is clearly highly material to the financial statements and will therefore have an implication for the audit. The whole engagement should be approached as high risk and with a high degree of professional skepticism.

The firm may wish to consider whether it is appropriate to withdraw from the engagement (if this is possible under applicable law and regulation). However, this could result in a tipping off offence being committed, as on withdrawal the reasons should be discussed with those charged with governance.

If Lark & Co continue to act as auditor, the audit opinion must be considered very carefully and the whole audit subject to second partner review, as the firm faces increased liability exposure. Legal advice should be sought.

**Tutorial note:** *Credit will also be awarded for discussion of other relevant matters, such as fraud, internal control deficiencies and audit implications.*

- (ii) The audit senior should report the situation in an internal report to Lark & Co's Money Laundering Reporting Officer (MLRO). The MLRO is a nominated officer who is responsible for receiving and evaluating reports of suspected money laundering from colleagues within the firm, and making a decision as to whether further enquiries are required and if necessary making reports to the appropriate external body.

Lark & Co will probably have a standard form that should be used to report suspicions of money laundering to the MLRO.

**Tutorial note:** *According to ACCA's Technical Factsheet 145 Anti-Money Laundering Guidance for the Accountancy Sector, there are no external requirements for the format of an internal report and the report can be made verbally or in writing.*

The typical content of an internal report on suspected money laundering may include the name of the suspect, the amounts potentially involved, and the reasons for the suspicions with supporting evidence if possible, and the whereabouts of the laundered cash.

The report must be done as soon as possible, as failure to report suspicions of money laundering to the MLRO as soon as practicable can itself be an offence under the money laundering regulations.

The audit senior may wish to discuss their concerns with the audit manager in more detail before making the report, especially if the senior is relatively inexperienced and wants to hear a more senior auditor's view on the matter. However, the senior is responsible for reporting the suspicious circumstances at Heron Co to the MLRO.

**Tutorial note:** *ACCA's Technical Factsheet 145 states that: 'An individual may discuss his suspicion with managers or other colleagues to assure himself of the reasonableness of his conclusions but, other than in group reporting circumstances, the responsibility for reporting to the MLRO remains with him. It cannot be transferred to anyone else, however junior or senior they are.'*

- (b) The term professional skepticism is defined in ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with ISAs* as follows: 'An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence'.

Professional skepticism means for example, being alert to contradictory or unreliable audit evidence, and conditions that may indicate the existence of fraud. If professional skepticism is not maintained, the auditor may overlook unusual circumstances, use unsuitable audit procedures, or reach inappropriate conclusions when evaluating the results of audit work. In summary, maintaining an attitude of professional skepticism is important in reducing audit risk.

IFAC's *Code of Ethics for Professional Accountants* also refers to professional skepticism when discussing the importance of the auditor's independence of mind. It can therefore be seen as an ethical as well as a professional issue.

In the case of the audit of Coot Co, the audit junior has not exercised a sufficient degree of professional skepticism when obtaining audit evidence. Firstly, the reliability of the payroll supervisor's response to the junior's enquiry should be questioned. Additional and corroborating evidence should be sought for the assertion that the new employees are indeed temporary.

The absence of authorisation should also be further investigated. Authorisation is a control that should be in place for any additions to payroll, so it seems unusual that the control would not be in place even for temporary members of staff.

If it is proved correct that no authorisation is required for temporary employees the audit junior should have identified this as a control deficiency and made a management letter point to be reported to those charged with governance.

The contradictory evidence from comments made by management also should be explored further. ISA 500 *Audit Evidence* states that 'if audit evidence obtained from one source is inconsistent with that obtained from another... the auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter'.

Additional procedures should therefore be carried out to determine which source of evidence is reliable. Further discussions should be held with management to clarify whether any additional employees have been recruited during the year.

The amendment of payroll could indicate that a fraud ('ghost employee') is being carried out by the payroll supervisor. Additional procedures should be conducted to determine whether the supervisor has made any other amendments to payroll to determine the possible scope of any fraud. Verification should be sought as to the existence of the new employees. The bank accounts into which their salaries are being paid should also be examined, to see if the payments are being made into the same account.

Finally, the audit junior should be made aware that it is not acceptable to just put a note on the file when matters such as the lack of authorisation come to light during the course of the audit. The audit junior should have discussed their findings with the audit senior or manager to seek guidance and proper supervision on whether further testing should be carried out.

- 4 (a)** The business venture proposed by Grouse Co's managing director, while potentially lucrative for the audit firm, would create significant threats to objectivity. A financial interest in a joint venture such as the one being proposed is an example of a close business arrangement given in IFAC's *Code of Ethics for Professional Accountants*.

According to the *Code*, a close business relationship between an audit firm and the audit client or its management, which arises from a commercial relationship or common financial interest, may create self-interest or intimidation threats. The audit firm must maintain independence, and the perception of independence will be affected where the audit firm and client are seen to be working together for mutual financial gain.

Unless the financial interest is immaterial and the business relationship is insignificant to the firm and the client or its management, the threat created by the joint venture would be so significant that no safeguards could reduce the threat to objectivity to an acceptable level. Therefore, unless the financial interest is immaterial and the business relationship is insignificant, the business relationship should not be entered into.

There would also be ethical issues raised if Raven & Co were to sell the software packages to audit clients. First, there would be a self-interest threat, as the audit firm would benefit financially from the revenues generated from such sales. Full disclosure would have to be made to clients in order for them to be made aware of the financial benefit that Raven & Co would receive on the sale.

Second, there would be a self-review threat, as when performing the audit, the audit team would be evaluating the accounting software which itself had sold to the audit client, and auditing tax figures generated by the software. It is difficult to see how this threat could be reduced to an acceptable level as the accounting and tax software would be fundamental to the preparation of the financial statements.

Third, by recommending the software to audit clients, it could be perceived that the audit firm is providing a non-audit service by being involved with tax calculations, and providing IT systems services. The provision of non-audit services creates several threats to objectivity, including a perception of taking on management's responsibilities. Risks are heightened for audit clients that are public interest entities, for example, the audit firm should not be involved with tax calculations for such clients according to IFAC's *Code*.

If having considered the ethical threats discussed above, Raven & Co still wishes to pursue the business arrangement, they must cease to act as Grouse Co's auditors with immediate effect. The lost income from the audit fee of Grouse Co should also be taken into account, as it is a 'significant' client of the firm.

The potential commercial benefits of the business venture should be considered carefully, as there may be little demand for the suggested product, especially as many software packages of this type are already on the market. Also, the quality of the software developed should be looked into, as if Raven & Co recommends inferior products they will lose customers and could face bad publicity.

Finally, if Raven & Co decides to go ahead with the joint venture, the partners would need to consider if such a diversification away from the firm's core activity would be advisable. The partners may have little experience in such a business, and it may be better for the firm to concentrate on providing audit and assurance services.

- (b) It appears that a surgeon is carrying out medical procedures without the necessary qualifications. This could clearly lead to serious damage being caused to a patient while undergoing laser eye surgery, and indeed this seems to have already occurred. The medical profession is highly regulated, and it is important for the auditor to consider obligations in the event of any serious breach of laws and regulations relevant to Plover Co.

It is management's responsibility that laws and regulations are followed, and auditors are not expected to prevent or detect non-compliance, especially non-compliances which have limited impact on the financial statements.

ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements* provides relevant guidance. It is required that if the auditor becomes aware of a suspected non-compliance, an understanding of the nature of the act and the circumstances in which it occurred should be obtained.

Therefore the auditor should establish whether it is the case that the surgeon is not qualified, possibly through reviewing the personnel file of the surgeon or discussing with the person responsible for recruitment.

The auditor should also discuss the matter with management and/or those charged with governance. It may be that they are unaware of the surgeon's apparent lack of qualifications, or possibly there is an alternative explanation in that the surgeon is qualified to perform laser eye surgery but does not possess a full medical qualification.

The potential impact of the apparent non-compliance should be evaluated. In this case, Plover Co could face further legal action from dissatisfied or injured patients, fines and penalties from the regulatory authorities and its going concern may be in jeopardy if that authority has the power to revoke its operating licence. If these potential effects are considered to be material to the financial statements, legal advice may need to be obtained.

In the event that the surgeon's work is in breach of relevant laws and regulations, management should be encouraged to report the non-compliance to the relevant authority.

If management fail to make such a disclosure, the auditor should consider making the necessary disclosure. However, due to the professional duty to maintain the confidentiality of client information, it is generally not acceptable to disclose client-related matters to external parties.

ACCA's *Code of Ethics and Conduct* provides additional guidance, stating that a member may disclose information which would otherwise be confidential if disclosure can be justified in the public interest. There is no definition of public interest which places members in a difficult position as to whether or not disclosure is justified. Matters such as the gravity of the situation, whether members of the public may be affected, and the possibility and likelihood of repeated non-compliance should be considered.

Determination of where the balance of public interest lies will require very careful consideration and it will often be appropriate to take legal advice before making a decision. The reasons underlying any decision whether or not to disclose should be fully documented.

The fact that a legal claim has been filed against Plover Co means that the audit work on provisions and contingent liabilities should be extended. Further evidence should be obtained regarding the legal correspondence, in particular the amount of the compensation claim. The date of the claim and the date of the medical incident to which it relates should also be ascertained in order to determine whether a provision for the claim should be recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, or whether a note to the financial statements regarding the non-adjusting event should be made.

**Tutorial note:** *Per IAS 37 commencing major litigation arising solely out of events that occurred after the year end is an example of a non-adjusting event after the reporting period.*

The audit firm may wish to consider the integrity of the audit client. If the management of Plover Co knowingly allowed an unqualified person to carry out medical procedures then its integrity is questionable, in which case Raven & Co may wish to resign from the audit appointment as soon as possible. This is especially important given the legal claim recently filed against the client, which could result in bad publicity for Plover Co, and possibly by association for Raven & Co.

## 5 (a) Matters to consider

The total cost of the new processing area of \$5 million represents 2.9% of total assets and is material to the statement of financial position. The borrowing costs are not material to the statement of financial position, representing less than 1% of total assets; however, the costs are material to profit representing 10% of profit before tax.

The directly attributable costs, including borrowing costs, relating to the new processing area should be capitalised as property, plant and equipment. According to IAS 23 *Borrowing Costs*, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The borrowing costs should be capitalised only during the period of construction, with capitalisation ceasing when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

In this case, the new processing area was ready for use on 1 September, so capitalisation of borrowing costs should have ceased at that point. It seems that the borrowing costs have been appropriately capitalised at \$100,000, which represents six months' interest on the loan ( $\$4\text{m} \times 5\% \times 6/12$ ).

The new processing area should be depreciated from 1 September, as according to IAS 16 *Property, Plant and Equipment*, depreciation of an asset begins when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

There should therefore be five months' depreciation included in profit for the year ended 31 January 2012, amounting to \$138,889 ( $\$5\text{m}/15 \text{ years} \times 5/12$ ).

#### Evidence

- A breakdown of the components of the \$4.9 million capitalised costs (excluding \$100,000 borrowing costs) reviewed to ensure all items are eligible for capitalisation.
- Agreement of a sample of the capitalised costs to supporting documentation (e.g. invoices for tangible items such as cement, payroll records for internal labour costs).
- A copy of the approved budget or capital expenditure plan for the extension.
- An original copy of the loan agreement, confirming the amount borrowed, the date of the cash receipt, the interest rate and whether the loan is secured on any assets.
- Documentation to verify that the extension was complete and ready for use on 1 September, such as a building completion certificate.
- Recalculation of the borrowing cost, depreciation charge and carrying value of the extension at the year end, and agreement of all figures to the draft financial statements.
- Confirmation that the additions to property, plant and equipment are disclosed in the required note to the financial statements.

- (b) The titles and positioning of the two paragraphs included in the extract are not appropriate. According to ISA 705 *Modifications to the Opinion in the Independent Auditor's Report*, when the auditor modifies the opinion, a paragraph should be placed immediately before the opinion paragraph entitled 'Basis for Adverse Opinion', which describes the matter giving rise to the modification. This should then be followed by the opinion paragraph, which should be entitled 'Adverse Opinion'. In this case, the titles are incorrect, and the paragraphs should be switched round, so that the basis for modification is provided before the opinion.

The description and explanation provided for the adverse opinion is not sufficient, for a number of reasons. Firstly, the matter is not quantified. The paragraph should clearly state the amount of \$10.5 million, and state that this is material to the financial statements.

The paragraph does not say whether the pension plan is in surplus or deficit, i.e. whether it is an asset or a liability which is omitted from the financial statements.

There is no description of the impact of this omission on the financial statements. Wording such as 'if the deficit had been recognised, total liabilities would increase by \$10.5 million, and shareholders' equity would reduce by the same amount' should be included.

It is not clear whether any accounting for the pension plan has taken place at all. As well as recognising the plan surplus or deficit in the statement of financial position, accounting entries are also required to deal with other items such as the current service cost of the plan, and any actuarial gains or losses which have arisen during the year. Whether these have been omitted as well, and their potential impact on profit or equity is not mentioned.

No reference is made to the relevant accounting standard IAS 19 *Employee Benefits*. Reference should be made in order to help users' understanding of the breach of accounting standards that has been made.

The use of the word 'deliberate' when describing the omission of the pension plan is not professional, sounds accusatory and may not be correct. The plan may have been omitted in error and an adjustment to the financial statements may have been suggested by the audit firm and is being considered by management.

Finally, it is unlikely that this issue alone would be sufficient to give rise to an adverse opinion. ISA 705 states that an adverse opinion should be given when misstatements are both material and pervasive to the financial statements. The amount of the deficit, and therefore the liability that should be recognised, is \$10.5 million, which represents 6% of total assets. The amount is definitely material, but would not be considered pervasive to the financial statements.

**Tutorial note:** According to ISA 705 if a misstatement is confined to specific elements of the financial statements, it would only be considered pervasive if it represents a substantial proportion of the financial statements.

1 (a) (i) Audit implications of Canary Co acquisition

Up to 1½ marks for each implication explained (3 marks maximum for identification):

- Develop understanding of Canary Co business environment
- Document Canary Co accounting systems and controls
- Perform detailed analytical procedures on Canary Co
- Communicate with previous auditor
- Review prior year audit opinion for relevant matters
- Plan additional work on opening balances
- Determine that Canary Co is a significant component of the Group
- Plan for audit of intra-company transactions
- Issues on auditing the one month difference in financial year ends
- Impact of acquisition on analytical procedures at Group level
- Additional experienced staff may be needed, e.g. to audit complex goodwill

Maximum marks

8

(ii) Risk of material misstatement

Up to 1½ marks for each risk (unless a different maximum is indicated below):

- General risks – diversification, change to group structure
- Goodwill – contingent consideration – estimation uncertainty (probability of payment)
- Goodwill – contingent consideration – measurement uncertainty (discounting)
- Goodwill – fair value of net assets acquired
- Goodwill – impairment
- Identify that the issues in relation to cost of investment apply also in Crow Co's individual financial statements (1 mark)
- Loan stock – premium on redemption
- Loan stock – accrued interest
- Loan stock – inadequate disclosure
- Identify that the issues in relation to loan stock apply to cost of investment in Crow Co's individual financial statements (1 mark)
- Online sales and risk relating to revenue recognition (additional 1 mark if calculation provided of online sales materiality to the Group)
- No group accounting policy for online sales
- Canary Co management have no experience regarding consolidation
- Financial performance of Crow Co and Starling Co deteriorating (up to 3 marks with calculations)
- Possible misstatement of Canary Co revenue and profit
- Grant received – capital expenditure
- Grant received – amount not yet spent
- New IT system
- Starling Co – no finance director in place at year end

Maximum marks

18

(iii) Goodwill

Generally 1 mark per specific procedure (examples shown below):

- Confirm acquisition date to legal documentation
- Confirm consideration details to legal documentation
- Agree 100% ownership, e.g. using Companies House search/register of significant shareholdings
- Vouch consideration paid to bank statements/cash book
- Review board minutes for discussion/approval of acquisition
- Obtain due diligence report and agree net assets valuation
- Discuss probability of paying contingent consideration
- Obtain management representation regarding contingency
- Recalculate goodwill including contingency on a discounted basis

Maximum marks

5

**(b) Ethical matters**

Generally 1 mark per comment:

- Reasonable for partner to attend board meetings
- But must avoid perception of management involvement
- Partner must not be appointed to the board
- Seconded manager would cause management and self-review threat
- Safeguards could not reduce these threats to an acceptable level
- Some recruitment services may be provided – interviewing/CV selection
- But avoid making management decision and put safeguards in place

Maximum marks

**Maximum**

6

**37**

**2 (a) (i) Matters to be considered in agreeing the terms of the engagement**

Up to 1½ marks for each matter identified and explained (2 marks maximum for identification):

- Management's responsibilities
- Intended use of the information and report
- The contents of the business plan
- The period covered by the forecasts
- The nature of assumptions used in the forecasts
- The format and planned content of the assurance report

Maximum marks

6

**(ii) Procedures on forecast financial information**

Up to 1 mark for each procedure (brief examples below):

- General procedures examples:
  - o Re-perform calculations
  - o Consistency of accounting policies used
  - o Discuss how joint venture has been included
  - o General analytical procedures
- Procedures on income statement:
  - o Discuss trends – allow up to 3 marks for calculations performed and linked to procedures
  - o Review and compare breakdown of costs
  - o Recalculate profit on disposal, agreement of components to supporting documentation
- Procedures on statement of financial position:
  - o Agree increase in property, plant and equipment to capital expenditure budget
  - o Discuss working capital trends – allow 2 marks for calculations performed and linked to procedures
  - o Agree movement in long-term borrowings to new loan documentation
  - o Obtain and review forecast statement of changes in equity and confirm validity of reconciling items

Maximum marks

13

**(b) (i) Audit procedures on costs of closure**

Generally 1 mark per specific procedure, examples given below:

- Review board minutes for discussion and date of decision
- Review detailed, formal plan and date of its approval
- Review any public announcement and the date it was made
- Physically inspect factory prior to year end for evidence of dismantling of assets
- Consider whether costs included are relevant (redundancies and lease cancellation fees are the most common type of relevant costs included)
- Agree relevant costs to supporting documentation
- Review note to financial statements for accuracy and completeness

Maximum marks

6

**(ii) Problems in measuring and reporting on social and environmental performance**

Up to 1½ marks per comment discussed:

- Difficulties in defining and measuring targets and KPIs
- Problems in quantifying some measures, e.g. employee satisfaction
- Inadequate systems and controls to accurately measure
- Difficult to compare between companies or over time

Maximum marks

4

**Professional marks for the overall presentation of the notes, and the clarity of the explanation and assessment provided.**

Maximum marks

4

**Maximum**

**33**

**3 (a) (i) Implications of the audit senior's note**

Generally 1 mark for each matter discussed relevant to money laundering:

- Definition of money laundering
- Placement – cash-based business
- Owner posting transactions
- Layering – electronic transfer to overseas
- Secrecy and aggressive attitude
- Audit to be considered very high risk
- Senior may have tipped off the client
- Firm may consider withdrawal from audit
- But this may have tipping off consequences

Maximum marks

6

**(ii) Reporting that should take place**

Generally 1 mark for each comment:

- Report suspicions immediately to MLRO
- Failure to report is itself an offence
- Examples of matters to be reported (identity of suspect, etc)
- Audit senior may discuss matters with audit manager but senior responsible for the report

Maximum marks

3

**(b) Professional skepticism**

Generally 1 mark for each comment:

- Definition of professional skepticism
- Explain – alert to contradictory evidence/unusual events/fraud indicator (up to 2 marks)
- Part of ethical codes
- Coot Co – evidence is unreliable and contradictory
- Absence of authorisation is fraud indicator
- Additional substantive procedures needed
- Management's comments should be corroborated
- Control deficiency to be reported to management/those charged with governance
- Audit junior needs better supervision/training on how to deal with deficiencies identified

Maximum marks

6

**Maximum**

**15**



4 For each requirement, generally 1 mark for each matter discussed:

**(a) Grouse Co**

- Situation is a close business arrangement giving rise to threat to objectivity
- Explain self-interest threat
- Explain intimidation threat
- Only acceptable if financial interest immaterial and relationship insignificant
- Sale of software to audit clients would require full disclosure of financial benefit
- Sale of software to audit clients creates self-review threat
- Sale of software perceived as providing non-audit service
- Risks heightened for listed/public interest entities
- If enter business arrangement must withdraw from audit of Grouse Co
- Commercial consideration – demand for product
- Commercial consideration – experience of partners

Maximum marks

8

**(b) Plover Co**

- Potential breach of law and regulations
- Further understanding to be obtained
- Consider potential impact on financial statements
- Discuss with those charged with governance
- Management should disclose to relevant regulatory body
- Auditor could disclose in public interest
- Issues with confidentiality
- Take legal advice
- Extend audit work in relation to the legal claim
- Risk of material misstatement
- Consider integrity of audit client

Maximum marks

7

**Maximum**

**15**

**5 (a) New processing area**

Generally 1 mark for each matter/specific audit procedure:

**Matters:**

- Materiality calculation
- Borrowing costs are directly attributable to the asset
- Borrowing costs should be capitalised during period of construction
- Amounts are correctly capitalised
- Depreciate from September 2011
- Additions to non-current assets should be disclosed in note

**Evidence:**

- Review of costs capitalised for eligibility
- Agreement of sample of costs to supporting documentation
- Copy of approved capital expenditure budget/discuss significant variances
- Agreement of loan details to loan documentation
- Recalculation of borrowing costs, depreciation, asset carrying value
- Confirmation of completeness of disclosure in notes to financial statements

Maximum marks

8

**(b) Audit report**

Generally 1 mark per comment:

- Inappropriate headings
- Paragraphs wrong way round
- Amounts not quantified
- Impact on financial statements not described
- Unclear from audit report if any accounting taken place for the pension plan
- No reference made to relevant accounting standard
- Use of word 'deliberate' not professional
- Materiality calculation
- Discuss whether adverse opinion appropriate (up to 2 marks)

Maximum marks

7

**Maximum**

**15**